FREE BANKING

IN

CANADA

BY

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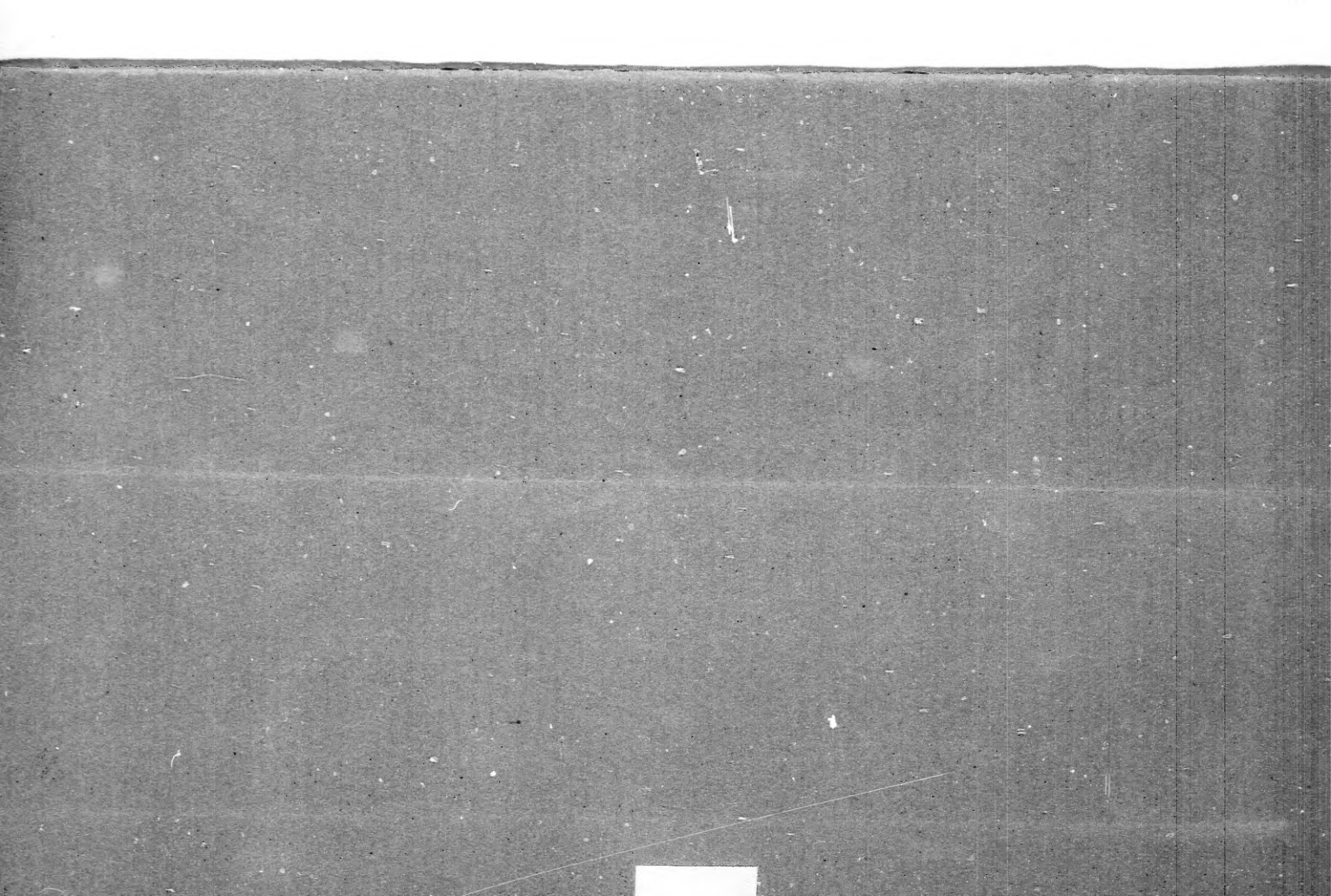

Reprinted from the March number of the Journal of the Canadian Bankers' Association Toronto Ont. 1894.

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I.

In the session of 1850 of the Legislative Assembly of Canada, the Honorable William Hamilton Merritt introduced a Bill "to establish freedom of banking in this Province, and for other purposes relative to Banks and Banking."

The group of large chartered banks which had hitherto carried on the banking business of the Province seemed to the general public to be insufficiently equipped with capital. Whether just or not, complaints of a lack of banking facilities were frequent, and there was a widespread demand, as often happens in comparatively undeveloped countries, for an increase of bank capital, for the extension of banking facilities, and particularly for the incorporation of small banks in the lesser towns where local opportunities for accommodation were much desired.

Important safeguards in the then existing banking system were the large capital stock of the banks, the small number doing business, the broad fields from which they drew their business, and the prudent and cautious manner in which that business was as a whole conducted. It was thought that in maintaining the system it would be very difficult for the Legislature to refuse to incorporate small banks for the small towns. But to allow such institutions the important privileges of the chartered banks, especially that of circulating notes which would be only a general charge against assets, seemed too great a risk. If small banks were to be established it was necessary to devise some other plan for issuing a sound currency. There was no bank of such predominant position that to it alone, as to the Bank of England, the function of issue could be entrusted, after the complete failure of Lord Sydenham's proposals of 1841 (largely, to be sure, through the influence of the chartered banks); there was no probability of establishing a Government Bank of Issue, and there was on the part of the Government itself such pressing financial need that any step towards relief would be welcome.

The Free Banking Laws of the State of New York had been in force since 1838. The commercial relations between the Upper Province and New York had long been close and important. When the economic conditions of the two countries were compared, New York, no doubt, appeared to marked advantage. New York's legislation, therefore, was not unlikely to be regarded by Canadians as recommended by the success and prosperity of the land in which it was in force. Nor was its influence necessarily the weaker because the judgment as to results was not entirely logical. So in spite of the early record of the system, in spite of the failure of twenty-nine banks in the first five years of the law's operation, and the fact that the special deposits of securities realized but 74 per cent. on the defaulted notes, Mr. Merritt's Bill was modelled after the Free Banking Laws of New York. Its objects are sufficiently described as (*a*) to provide for the establishment of small banks, (*b*) properly to secure their circulation, (*c*) to relieve, in part at least, the financial difficulties of the Government by widening the market for its securities, and at the same time so stimulating the demand as to raise their value.

II.

The measure as passed (13 and 14 Vic., cap. 21) first repealed the old laws of Lower Canada (Ord. L. C. 2 Vic. (3), cap. 57), "to regulate private banking and the circulation of the notes of private bankers," and of Upper Canada (7 Wm. IV., cap. 13), "to protect the public against injury from private banks." Henceforth it became lawful only for chartered banks or other corporations or persons authorized under the new Act to issue circulating notes, which were to be of the value of 5 shillings or over. Notes under 5 shillings were prohibited. So also circulation by unauthorized persons was forbidden on penalty of fines of £100.

The significant provision of the Act is the extension of the privilege of note issue "to other persons or corporations thereunto authorized as provided for herein." Individuals or general partners might establish banks, or joint stock companies might be formed to carry on the business, but in any case the bank was to have an office in but one place, and in but one city, town or village. Of the companies was required a minimum capital stock of

£25,000, divided into shares of £10 or more.* Articles of agreement in notarial form, showing the name, place of business, capital stock, number of shares, names and residences of the shareholders and the time when the company should begin and end, were the legal basis for organization. After the articles were duly filed in stipulated courts of record, the companies became incorporated, and the liabilities of the shareholders limited to double the amount of their subscribed stock. The total liabilities of a Joint Stock Bank were not allowed to exceed three times its capital stock. Every institution working under the Act was required to keep *bonâ fide* an office of discount and deposit, at all times to keep exposed in its place of business a list of its partners or shareholders, and to make detailed semi-annual returns to the Inspector General, as well as to submit to official inspection at the discretion of the Government.

In order to issue notes the banks thus formed were each obliged to deposit with the Receiver-General Provincial securities for not less than £25,000 currency ($100,000) par value in pledge for the redemption of their notes. Interest on the securities was to be paid to the depositor as it accrued, and against the bonds the Receiver-General was authorized to deliver to the bank an equal amount of registered notes, printed from plates furnished by the bank upon paper selected by the Receiver-General. When signed by the proper officer these notes were to become notes of the bank. In every case they were to be payable in specie on demand at the bank's place of business. They were to be marked "Secured by Provincial securities deposited with the Receiver-General," and were to be receivable for all duties and sums due to the Provincial Government, so long as the issuing bank redeemed its notes. These registered notes were exempt from the rate of 1 per cent. per annum levied upon the average monthly circulation of the chartered banks. The third or fiscal object of the Act is especially plain in that clause

* NOTE.—The denominations of pounds, shillings and pence used in this article are those of the so-called "Halifax Currency," the usual money of account in the British North American Colonies down to the latter half of the fifties, when the change was made to dollars, cents and mills. A pound currency was worth approximately $4 U. S. coin, and a pound stg. was valued at £1 4s. 4d. Halifax currency.

which permits the chartered banks to surrender their right of circulation against assets, and to secure from the Receiver-General registered notes in return for deposits of securities. Any of the corporations within the purview of the Act might deposit additional securities from time to time, and withdraw sums of not less than £5,000, provided that like amounts of the notes were returned to the Receiver-General and the required deposit of £25,000 maintained.

If, in case of suspension of specie payment and protest of the notes, the paper was not paid with interest at 6 per cent. within ten days after the requisition issued by the Inspector-General of the Province upon receipt of the protested notes, that officer was commanded to close the institution and wind up its affairs, should it have no valid excuse to offer for the default. The process of liquidation was to be completed by a Receiver appointed by the Receiver-General. His duty was *first* to pay off the notes from the proceeds of the securities on deposit. The remaining proceeds were then to be applied with the other assets to settlement of the remaining debts of the bank. But if insufficient funds were realized from the sale of the securities, the general assets of the bank were to be applied to the payment of the notes before they were used for the other claims. This is the first appearance in Canadian legislation of that principle of making bank notes a preferred claim, which, 30 years later, was embodied in the Bank Act of the Dominion.

III.

The Act to establish Freedom of Banking could hardly be called perfect. Time proved it ill-calculated to promote the ends of the Legislature which passed it. The amendments passed in the following years show that certain of its defects were recognized. From the very first it suffered severe criticism on the part of the English Lords of the Treasury. The most serious defect of the Act, in their opinion, was the lack of guarantee for the immediate convertibility of the notes on demand. Against the fancied completeness of Government obligations as "security," they cite the fall of Exchequer bills to 35 shillings discount in 1847. Anxious as always that the financial and monetary systems of the colonies should be sound, they warn the

Canadian Government against the reverses following too great an extension of the facilities which may be afforded by the use of paper money. The measure might cause Canadian securities to rise temporarily, but they would also be exposed to the risk of depreciation should it become necessary to throw them into the market in order to provide for the payment of bank notes. In the opinion of the Lords of the Treasury, the great protection against over issue was the constant maintenance of a proportionate reserve of specie against the outstanding circulation, with Government supervision and frequent publication of bank statements. They recommended the requirement of a specie reserve of one-third of the notes issued and of monthly statements.

The following year, accordingly, an amendment was passed requiring monthly statements from the free banks. It is plain that half yearly returns provided a basis for intelligent criticism to neither the Government nor the public. The period of one year in which to retire their circulation and begin operations under the new plan accorded by the Act of 1850 to banks or companies whose authority to issue notes had been withdrawn by the Act, was increased to five years, provided that in each year of the next four they should retire one-fourth of the average circulation during 1850, of notes not secured by a deposit of bonds. The requirement of a specie reserve of one-third was not adopted.

In the same session, the Assembly passed another Act with a view "to encourage the chartered banks to adopt as far as conveniently practicable, the principles of the General Banking Act in regard to the securing of the redemption of their bank notes." The real purpose, of course, was a further sale of bonds. The means were (*a*) a remission during the next three years of one-half the tax on circulation to those banks willing forthwith to restrict their circulation to the highest amount shown in the last statement, and at the end of three years to three-fourths of the average for 1849 and 1850; (*b*) at the end of the three years, entire exemption from the tax to banks with note circulation thus restricted; (*c*) permission to such banks to issue in excess of the restricted circulation further notes to the amount they should hold of gold or silver coin or bullion or debentures of any kind issued by the Receiver-General, the value of such securities to be reckoned at par; (*d*) exemption of these banks from the re-

quirement to deposit the debentures and to secure registered notes. But if failures occurred the proceeds of bonds thus held by the banks were to be applied exclusively to the redemption of outstanding notes.

The Act 16 Vic., cap. clxii. (session of 1853) was an attempt further "to encourage the issue by the Chartered Banks of notes secured" in this manner. They were permitted to issue notes in excess of the limit laid down by their charters, *i. e.*, the amount of their paid up capital stock, to the amount of the sums held by them in specie or debentures receivable in deposit by the Receiver-General, although the deposit of the securities was not required. The 1 per cent. tax upon circulation, also, was to be calculated only upon the sum by which the average during any period of the outstanding notes of a bank should exceed the average of the securities and specie which the bank had on hand.

These measures, though the original Act was copied from the New York law, seem strongly to reflect the influence upon Canadian legislators of Sir Robert Peel's Bank Act of 1844, and the Statutes of 1845, which dealt with Scotch and Irish banks. The plan of restricting that part of the circulation "unprotected" by special security, the extension to the banks of the privilege of indefinitely increasing circulation beyond that limit, provided equivalent values in specie or debentures were held, and the repeated efforts to provide as much as possible of the fiduciary currency with bond security, might not perhaps be conclusive evidence of this influence. The regulations might have been adopted after independent consideration, or to reach other ultimate ends than those sought by Lord Overstone, Sir Robert Peel and their followers. In Canada, too, the financial purpose, though the laws failed to afford the anticipated help, was highly influential.

But the influence of an effort to follow English example is strongly supported by the authority of Sir Francis Hincks in the Assembly at that time. Ten years before he had supported against his own party the proposals of Lord Sydenham for improving the Canadian currency by means similar to those suggested by Lord Overstone. As late as 1870 his views on the question were unchanged. The inference is confirmed by the

fact that in 1851 the Colonial Office itself advised the Canadians to adopt, as far as possible, the principles of Peel's Bank Act in their regulation of banking and currency. The authority of the officials in Downing Street and the usual promptness with which the colony carried out their recommendations, leave no doubt of the marked and even decisive effect of this factor in the "freedom of banking" legislation of 1852 to 1856. Following is the significant excerpt from the letter of C. E. Trevelyan for the Lords of the Treasury, enclosed in the despatch of Earl Grey, H. M. Principal Secretary of State for the Colonies, dated 24th June, 1851: "Although the establishment of "a bank in connection with the Government appears to have "been impracticable or inexpedient, it does not follow that some "modification of the scheme adopted in the United Kingdom "with respect to the circulation, the leading feature of which is "a limitation to the amount of notes issued on the credit of "securities, and the maintenance of a deposit of ~~securities~~ specie equal "to all issues exceeding that amount, might not still be attain-"able in Canada."

The possible dangers or faults of the original Act, pointed out for the Lords of the Treasury in the same letter, and noted by us on page 158, were not, on the whole, the source of much trouble in the working of the system. To discuss the other defects in the scheme, or what might be termed the errors in principle, would be to raise the questions of bond-based or specially secured bank circulation *versus* circulation as a general charge against assets, and of the system of many small local banks *versus* that of fewer large banks with branches. But for Canada, at least, these and the minor controversies they involve have been decided. What really prevented a thorough trial of so-called "Free Banking," and a complete experience of its results, whether for good or evil, was the inferior opportunity which it offered for banking profits. Very few banks began operations under the law; the system of chartered banks remained predominant and characteristic. The fate of the free banks will show how unequal was the struggle with these competitors. Nor is the reason far to seek.

The bonds receivable on deposit as note security bore interest at 6 per cent. Since they could be bought at less than

par, they netted as an investment a somewhat higher rate. The minimum deposit for a bank beginning business was £25,000 currency, or $100,000. The small banks, however, which it was expected to establish under this Act, would seldom need a capital greater than £25,000, and, even if they needed it, a greater sum would be hard to get in the localities whence the demand for such institutions came. But before a bank could begin business this hardly-gained capital was to be removed from the locality and locked up in debentures. In return for these, the free bank was to receive an equivalent amount in registered circulating notes. A chartered bank, on the other hand, acquired by the privilege of circulation a power of loaning to the community, in addition to its capital stock, the amount of its authorized note issue. To meet the needs of its district the free bank in our example was to derive from capital and circulation combined a fund of only £25,000, *i. e.*, the amount of its note issue, or rather so much of it as could be kept in circulation, a proportion which rarely reached 90 per cent., and in some cases did not exceed 50 per cent. In brief, £25,000 of the capital of the district was to be taken bodily away and replaced by notes, of which only a part were available for loaning purposes. If carried out, the scheme to provide banking facilities for poor communities was destined actually to diminish the loanable funds in the districts for whose benefit it was devised.

Intimately connected with this fault, is the fatal defect of the Act—the slight inducement to investment afforded by its provisions. With its capital locked up in debentures there remained to the free bank, besides its deposits, which need not be considered here, the £25,000 of registered notes for accommodation of the local public. Of these, we have seen that only 50 to 90 per cent. constituted the actual loaning fund which could be turned over several times a year in banking operations, and from which could be derived the additional and incidental profits that banks, in spite of usury laws and other hindrances, will contrive to secure whenever the markets permit. From an equal sum invested in one of the chartered banks could be gained the banking profit on the capital itself, and the circulation issued upon the credit of that capital.

The advantage, in favor of the chartered bank, apart from the important consideration of its control of much larger means—none of its capital being locked up in debentures—was approximately the difference between the banking profit on the amount of its capital and the interest on an equal amount invested in Government securities. In other words the chartered bank would get the greater return from both circulation and capital; the free bank from circulation alone, its capital being invested, by law, at a lower rate of interest.

This higher gain to be had from employing their funds in their own business, also caused the chartered banks, as a rule, to reject the encouragement offered by the Legislature so to invest those funds in debentures as to make them practically a permanent loan to the Government. And in a country where the best bank profits were moderate, other investors were slow and unwilling to engage in a form of banking in which the chances for gain were still more restricted.

IV.

In November, 1854, there came before the Legislature the question of the renewal of bank charters, and the increase of their capital stock. In this connection Sir Francis Hincks admitted that the public had not shown any great disposition to take advantage of the free banking law. He said further:

"First. He thought that the public wanted a large increase of banking capital.

"Second. There was not money in Canada to furnish that capital.

"Third. The country must get this capital from foreigners, and the people of Canada would have to consult foreigners as to the manner in which it should be done.

"Fourth. The country knew that no English capitalist was disposed to furnish money to Canada through the agency of private banks. But English capitalists would recognize the large chartered banks, because these banks had been known for many years as a safe means of investing capital. * * Capitalists had confidence in them, but they would not have confidence in private banks established under a new banking system. If the people wanted to increase their banking capital they must do so through the existing banks."

To the Bank of British North America, however, the new law had permitted a valuable privilege, denied it by its Royal Charter, but enjoyed by the other banks under their Colonial Charters, usually to the extent of one-fifth of their entire note issue. This was the right to issue notes of denominations under $4. December 31st, 1854, the British Bank held £162,125 of bonds, and had outstanding against them £153,750 of one and two dollar notes. Until the banks surrendered their small note circulation in 1870 it appears to have continued its issues under this Act. Three other banks were doing business at the close of 1854 under the Act. Their statements are as follows:

	Molsons' Bank, Montreal.	Niagara Dist. Bank, St. Catharines.	Zimmerman Bank, Clifton.	Total.
Capital in Provincial Debentures deposited with the Receiver-General..	£50,000	£50,000	£25,000	£281,125
Amount of registered notes outstanding and delivered to the banks by the Inspector-General..	50,000	49.999	24,500	278,249
Circulation	37,861	46,169	22,000	
Liabilities, including circulation	85,446	67,615	29,321	
Assets	136,840	101,642	49,931	

The next year operations reach the highest figure in the whole history of the Act, though only four banks appear in the statement.

	Bank of B. N. America.	Molsons' Bank.	Niagara Dist. Bank.	Zimmerman Bank.	Total.
Capital in Provincial Debentures deposited with the Receiver General ..	£170,708	£50,000	£50,000	£40,000	£310 708
Registered notes outstanding	169.750	49,794	49,999	40,000	309 549
Circulation		24,332	69,050*	40 000	
Liabilities		24,332	77,761	48,817	
Assets		79,100	133,285	54,585	

In 1855 the Legislature granted charters to the Molsons' Bank, the Zimmerman Bank and the Bank of the Niagara

* Also issues under charter.

District, and required as one of the conditions of the extended privileges, the increase of the capital stock of each to £250,000, of which, in each instance, at least £100,000 was to be subscribed before the bank began its new corporate existence.

After 1855 there was a steady falling off in the amount of securities deposited, notes outstanding against them, and notes in circulation. In the statement of 1856 the Provincial Bank and the Bank of the County of Elgin first appear, the former with a deposit of securities for $120,000 and notes for the same amount, the latter with securities for $100,000 and notes for $79,950. The newly chartered banks appear to have been retiring their secured notes. The total bond deposits are $1,114,633.33 (£278,658) and notes outstanding $1,080,684 (£270,171). In 1857 the figures have fallen to $770,319.33 and $769,730. In 1858 they are $730,503.33, and $729,531, and the Molsons' and the Zimmerman Banks disappear from the list. In 1859 the bond deposits are $730,503.33, and notes outstanding, $699,531; in 1860, $562,603.33, and $495,631, of which the British Bank stands for $440,933.33 and $373,964, about $100,000 less than in the statements for 1857 to 1859.

V.

The failure of the system had received the attention of the Legislative Assembly at least three years before. On March 6th, 1857, the Hon. Wm. Cayley introduced a Bill to discontinue the incorporation of joint stock banks and the issue of registered notes. The merchants and moneyed men of the Province were generally in favor of the older chartered system, he said, and even in 1855, the Assembly had decided to perpetuate it. Its decided superiority had been shown by the action of the three banks which had retired their registered notes and continued their business under charters. Wm. Hamilton Merritt was still in the Assembly, and in reaffirming his responsibility for the first Free Banking Act, he declared with a lofty disdain of the facts, that it was the "best system adopted in any country from the beginning of the world to the present time." "The sole cause of its being inoperative in Canada," he contended, "was that it had not been honestly carried out." Mr. Cayley's

Bill did not come up for the third reading, for what reason the debates give no evidence.

In 1859, the then Minister of Finance, the Honorable A. T. Galt, in moving for a select committee on banking and currency, referred to the tendency of the free banks to secure charters, and to the unimportant and limited character of the operations then carried on under the Act. Of the "Resolutions for a Bank of Issue or Treasury Department," which the Minister in 1860 based upon the investigations of this committee, the third provided for the repeal of the free banking law, with the permission to banks working under it to come under the general Act for all banks outlined in the other resolutions. But in these, as a whole, were proposed such revolutionary changes in the currency and banking system of the country that action upon them was indefinitely postponed.

By December 1861, the Niagara District Bank had nearly withdrawn its Provincial securities, and the Provincial and County of Elgin Banks had only $2,000 and $20,440 of bonds, respectively, on deposit. At the end of 1862, the British Bank held securities for $436,933.33; its registered notes amounted to $336,964, of which $130,505 were in circulation. But the Provincial Bank had deposits and circulation of only $9,729, and the Bank of the County of Elgin had disappeared both from the Government statement and the world of business. To all intents and purposes, free banking in Canada had run its course.

Six banks in all had taken advantage of the Act. To one of these, the Bank of British North America, the privileges acquired under the Act were doubtless of considerable value. It was enabled to issue notes of denominations originally forbidden by its Royal Charter, without much other inconvenience than a change in one of its accounts. For even before 1850, it had been the custom of the British Bank to hold among its more liquid assets a much larger amount of Provincial debentures than even its small-note circulation amounted to in after years. Two of the companies working solely under the free banking laws wearily struggled for three years (1856 to 1858) against the competition and prestige of the chartered banks, and then began

to retire their issues and wind up their business. The three banks earliest started under the Act soon applied for charters and secured them.

Of these the Zimmerman Bank had the shortest life. Founded in 1854 by a person of means, it was to an unusual degree the creature of one man. It seems, however, to have been well and honorably managed by the capitalist whose name it bore. In 1858 the charter of 1855 was amended by changing the name of the institution to the "Bank of Clifton," and extending the time for the subscription and payment in full of its capital stock. But in spite of these favors and of the extraordinary privilege "that the bank notes and bills in circulation shall be of whatsoever value the Directors shall think fit to issue the same, but none shall be under the value of 5 shillings ($1)," the bank was soon wound up after the death of Mr. Zimmerman. In 1863 its charter was repealed.

The Bank of the Niagara District, with its head office in St. Catharines, Canada West, found difficulty from the first in securing the capital required by its charter. The Act of 1855 required subscription and payment in full of the million dollars in five years. In 1857 an indulgent Legislature extended the term to 1861; in 1861 to 1866; in 1863 the capital stock requirement was reduced to $400,000, and the time for paying it up extended to 1865. The bank had a fairly successful career until it suffered large losses through the failures of Jay Cooke & Co., and others, in 1873. Hardly able longer to carry on an independent business, it was amalgamated early in 1875 with the Imperial Bank of Canada. The shares of the Niagara District Bank were exchanged for those of the Imperial, according to the relative value of the two stocks, and thereafter the former bank disappeared as a separate institution.

Out of the five originally "free banks," but one, the Molsons' Bank of Montreal, has survived, and is now an institution of standing and importance.

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